view from the OUTER

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Tim Rocks
Chief Investment Officer
Timothy Rocks

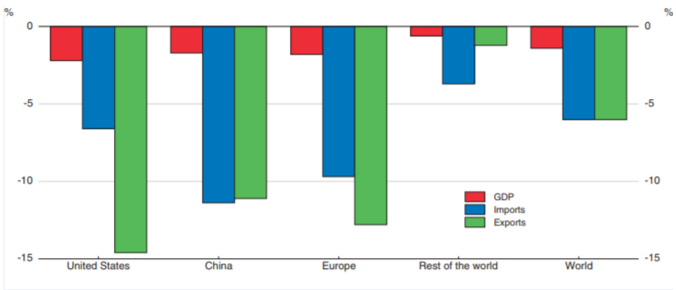
Trading the war

An important role for tactical asset allocation is protecting portfolios against discrete market-moving events that are hard to predict. A US/China trade war is now shaping as a binary event and the impact on markets could be large because investors appear to be assuming that there will not be an escalation. The 6th of July could be a major day for this as this is the day that the US starts to collect tariffs.

Estimates are that the direct impact of the tariffs on GDP will be relatively small at the start. However the impact on markets could be larger because:

- China could retaliate by selling US treasuries, depreciating the yuan or directly targeting other US exports.
- The effect on US profits could be larger given US companies generate 40% of revenue from offshore and margins are at risk.
- US valuations could be affected by the uncertainty around the event.
- Higher US inflation could force the Fed to extend the rate rise cycle.

Estimated Impact of 10% tariff increase



Source: OECD Economic outlook, November 2016

Recommendations

Our recommendations for investors are:

1. This is an opportunity to take profits in equity markets that have made good returns over the past year such as Australia, emerging markets including China, and US stocks that are vulnerable because they sell to China or produce there (such as device manufacturers).
2. Reduce overall equity weightings until the trade fog clears. Other risks are also elevated in the short term such as the Chinese and broader global economic outlook. We recommend that these funds be parked in cash for the time being; this is line with the asset allocation changes we made during May.
3. Increase portfolio hedging. Investor could consider other hedging strategies such as increasing holdings in gold, and buying futures, put options and inverse ETFs to hedge portfolios directly.

Trading the war

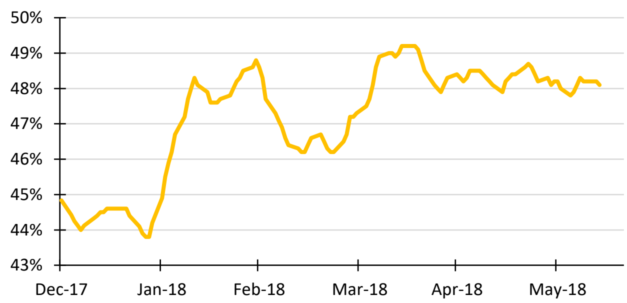
One of the main roles of tactical asset allocation is to protect portfolios when they are threatened by short term risks from political, policy, regulatory or economic events. The ongoing trade tensions between the US and China loom as one such event.

6th July is the critical date

As events currently stand, 6th July is looming as a critical date because this is the day that the US will start collecting tariffs on $50 billion of merchandise imported from China. Behind-the-scenes negotiations are continuing to try and get a deal done before this date but a comprehensive deal before then is looking increasingly unlikely for a few reasons:

- Trump is incentivised to maintain the rage given a recent jump in polling; voters clearly like his more aggressive stance on global trade. Given the mid-term elections in November, he may feel that it would be better to wait until after this to do a deal.

Trump Approval Rating



Source: Thomson Reuters Datastream, Evans & Partners

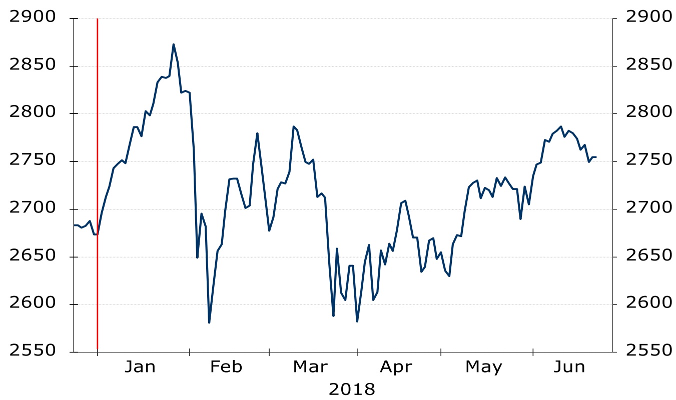
- There was quite a negative reaction to concessions that Trump tried to give to the Chinese telco, ZTE. In fact Trump has backed himself into a corner because his stated goal of achieving a $200 billion change in the trade deficit between the US and China is almost impossible to achieve in a short period. As a result any deal will appear like a concession.

Binary outcome

The challenge for investors is that we are now at the point where this is a binary outcome. If we go past 6th July without a deal then it appears that the trade war is genuinely on and that the chances of further escalation are much increased.

My view is that investors are not ready for an escalation. In February and March the S&P 500 was weaker based on trade concerns but since that time investors have learnt to ignore Trump bluster. They have become too complacent about the trade outcome and too quick to dismiss the White House rhetoric.

S&P 500 Index

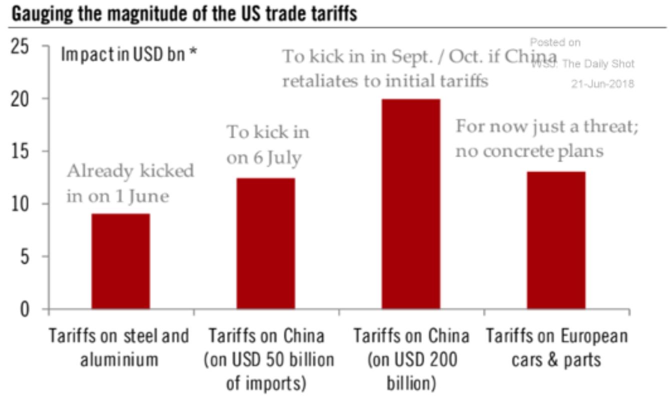


Source: Thomson Reuters Datastream, Evans & Partners

How bad could it get?

Part of the reason that investors are complacent is that the direct economic impact of the tariffs announced to date are relatively small. Estimates are that the combined effect of the steel tariffs already implemented and the July 6th tariffs will be around $US20 billion or about 0.1% of GDP. The next round, which may be introduced in September, may double this.

Gauging the magnitude of the US trade tariffs



* *impact calculated as tariff rate multiplied bytotal imports as of 2017. Assumes a 25% tariff rate for potential tariff on EU cars and parts rather than 35% Trump floated.*
Source: Pictet WM-AA&MR, US ITC.

An impact of 0.2% of GDP would be manageable. These, however, are only estimates of the immediate impact of the tariffs. If the trade-war genuinely escalates there will be other effects, particularly from any response from China that aims to punish the US for its behaviour. If China decides that it wants to create headaches for the US, some of its options are:

- **Selling US bonds (or threatening to)**. China holds $1.2 trillion of US treasury bonds – around 20% of outstanding issuances. Such an announcement could create some turmoil in bond markets.
- **A currency depreciation**. A yuan devaluation, like the one Beijing unexpectedly carried out in August 2015, could be used to offset some of the effect of tariffs.
- **Curb US oil shipments**. China is one of the biggest importers of U.S. crude oil at 400kb/d.
- **Suspend rare earth exports**. These are critical components of tech goods. China controls 97% of Tungsten and Molybdenum that are used in mobile phones. China dominates this market because their mining is environmentally hazardous and most other countries have not allowed it.
- **Restrict tourism and education flows to the US**.

Our assumption is that China will be reluctant to escalate. China has much more to lose than the US given the importance of US exports to the economy (around 5% of GDP). Also many of the other US demands such as intellectual property protections and greater access for US companies to China are consistent with China's broader reform agenda.

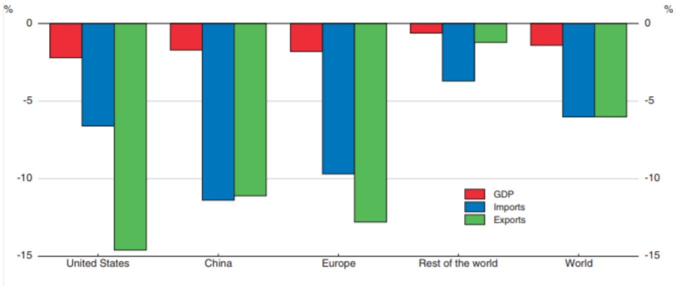
However, as the issue becomes more antagonistic and more about winners and losers than a negotiation, then China may feel compelled to retaliate in one of the ways above.

Impact of full-blown trade war

Several organisations have attempted to estimate the impact of a full trade war. The OECD estimates that a 10% increase in tariffs between the US, Europe and China will reduce global GDP by 1.4% and US GDP by 2.2% over the first year. A more comprehensive study by McKibbin and Stoeckel (2017)[1] from ANU found a US impact of 1.3% and a global impact of 1.4%.

These estimates take account of the impact on inflation and Fed policy. Tariffs will raise inflation and, given that inflation is already a focus of monetary policy, this could force the Fed to extend its raise rise cycle. Around 20% of US consumer goods come from China, so the impact on inflation could be significant.

Estimated Impact of 10% tariff increase



Source: OECD Economic Outlook, November 2016

Our assumption is that US equity markets will be affected by even more than these effects suggest. When thinking about the impact on US markets, it is important to consider that earnings of US companies may be more vulnerable for a few reasons:

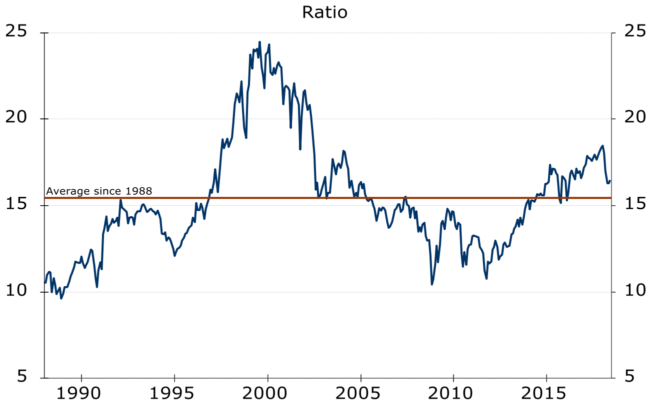
- US companies are heavily reliant on exports with around 40% of revenue coming from offshore. This suggests that the earnings impact will be larger than the impact on GDP in the studies above.
- Margins of US companies could be hurt which will exaggerate the impact. US companies may be forced to absorb a large part of the effects of any tariffs imposed in China given that operating conditions in China are competitive.
- US companies will be specifically targeted by Chinese companies. This has already been the case in the auto sector.

1 "*Some Global Effects of President Trump's Economic Program*" CAMA Working Paper 53/2017 August 2017 Warwick J. McKibbin and Andrew Stoeckel.

- US tech companies with Chinese factories may be particularly affected since supply chains could be disrupted. Many US companies import components or entire products from China, particularly in tech. Companies like Apple, Lenovo, Broadcom, Micron, and NVIDIA have supply chains that extend into China.

This suggests that the overall impact on US profits would be larger than the impact on GDP – at a rough guess closer to 5% over the next year or so. Further these effects on profits could be affected by any impact on valuations as investors price-in some risk premium for the unknown effects of the conflict. US valuations remain elevated by historical standards. A 5% fall in the US forward PE and a 5% fall in earnings suggests the potential for markets to be 10% lower at some point over the next year if the trade war continues to escalate.

US One-Year Forward PE



Source: Thomson Reuters Datastream, Evans & Partners

Positioning for a trade war

An important role for tactical asset allocation is protecting portfolios against discrete events that are hard to predict. We do not consider ourselves to be experts on US trade or to have better insights than most on what will occur. But this issue appears to be important for markets because it is a binary event (ie there will be an escalation in the trade war or there won't) and has the potential to have a material effect on earnings and valuations.

Further, there is the potential for a skewed outcome. If a deal gets struck on 5th July the impact on markets will be small because this is the consensus view amongst investors. However, if there is an escalation of the conflict, markets could move sharply. We are assuming that we will have more clarity on this by 6th July although the uncertainty could extend well beyond this.

Our recommendations for investors are:

1. This is a good opportunity to take profits in markets that have made good returns over the past year. This includes:
   - The overall Australian markets where recent gains have been strong;
   - Emerging markets including China that have made good returns since early 2016;
   - US stocks that are particularly vulnerable including companies that sell to China or produce there (such as device manufacturers).
2. Reduce overall equity weightings until the trade fog clears. Other risks that are also elevated in the short term including those around the Chinese and broader global outlook. Where there is a choice, hedged international equities should be sold before unhedged equities because there is some chance that the $A falls further in this scenario. We recommend that this be parked in cash for the time being; this is line with the asset allocation changes we made during May.
3. Increase portfolio hedging. Investor could consider other hedging strategies such as:
   - Increasing holdings in gold; and
   - Buying futures, put options and inverse ETFs to hedge portfolios directly.

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